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***October 25, 2002***

***To the Citizens of the Commonwealth of Massachusetts,  
Governor Jane Swift, and Honorable Members of the General  
Court***

I am pleased to present to you the Statutory Basis Financial Report of the Commonwealth for the fiscal year ended June 30, 2002 (FY02).

During the 1990's the Commonwealth enjoyed unprecedented growth. In FY02, the economy slowed. The traumatic events of September 11<sup>th</sup> and the nearly complete shutdown of economic activity for the remainder of September 2001 exacerbated an already slowing economy. These events were coupled with a related meltdown of corporate profits and confidence due to private sector disclosure scandals. The effect on the Commonwealth was a downturn in tax revenue that has been worse than forecast both in depth and length. The reduction in taxes was approximately \$2.4 billion or 15.2%, largely from income and corporate taxation. To put the reduction in perspective, \$2.4 billion was larger than the Commonwealth's *entire* tax revenue collected in 1975. Luckily, during the decade from 1993 through and including 2002, tax revenues grew at an average of 4.4% and total governmental revenues grew at an average of 6.1% annually.

During the same time period, budgeted spending in the Commonwealth's major programs, including direct local aid, medicaid and higher education, grew at an annual average of 6.3%. The largest growth in the budget was to these three major programs, with spending on direct local aid doubling in the last decade. Combined, these three major programs encompass \$11.5 billion, half of all of the budgetary programs of the Commonwealth.

With these fiscal challenges in mind, I must report that as of June 30, 2002, that the budget was balanced but only with significant use of reserves and the financial condition of the Commonwealth will continue to present challenges as we reduce the use of reserves and constrain spending within current revenues. As of August 30, 2002, the Federal Reserve Bank of Boston, in its monthly "New England Economic Indicators," reported that the number unemployed in our Commonwealth has increased to 174,000, or a rate of 5.2%. This rate is under the federal rate of 5.7%, but it has risen dramatically even from last year. The same report shows that the consumer confidence index of the present situation has slipped in the Commonwealth from a rate of 116 a year ago, to 68 today.

The largest component of the Commonwealth's reserves is the Stabilization Fund. The Stabilization Fund, funded primarily during the last decade, provides the Commonwealth with a strategic tool to assist the Commonwealth through this difficult time. The Stabilization Fund may be used in three circumstances. The first is to make up any

difference between the actual state revenues and the allowable state revenues in the case of a revenue shortfall. The second is to replace federal funds in the case of a shortfall. Finally, the fund may be used for any event that threatens the health, safety, welfare, or stability of the Commonwealth, including an economic downturn. A significant portion of this fund, along with other reserves, was used in FY02 to minimize the impact of the dramatic drop in revenues. As we go through FY03 and beyond, the challenge will be to use it wisely to help the Commonwealth transition to this new economic reality, not delay necessary changes that must be made. In previous years, year-end transfers of budget surpluses were made to the capital project funds to make strategic investments for the management of the Commonwealth's capital budget, to defease high interest debt that otherwise could not be refunded, and the continuation of reserves funding. These reserve transfers proved to be useful in FY02, as they helped fund operations.

### ***Financial Highlights***

To meet the fiscal challenges of FY02 and beyond, the Commonwealth took extraordinary measures to remain in fiscal balance. The table at the right shows significant balances used to close FY02 and those authorized for use in the FY03 General Appropriation Act.

***Prior Year Surpluses Used to Balance  
Budgetary Funds:  
(Amounts in Thousands)***

	<b><u>FY02</u></b>	<b><u>FY03 (projected)</u></b>
Stabilization Fund	\$ 1,030,000	\$ 550,000
Transitional Escrow Fund	422,000	-
Health Care Security Trust Fund	60,000	-
Caseload Mitigation Fund	56,000	75,000
Medical Security Trust Fund	35,000	-
Tax Reduction Fund	33,605	-
MBTA Infrastructure Renovation Fund	24,000	-
Massachusetts Clean Elections Fund	-	20,164
Ratepayer Parity Trust	-	31,793
Operating Surpluses Transferred from Capital Projects Funds	<u>176,174</u>	<u>-</u>
Total Completed and Estimated Budgetary Transfers	<u><u>\$ 1,836,779</u></u>	<u><u>\$ 676,957</u></u>

- The Commonwealth transferred over \$1 billion out of Stabilization during FY02 as well as \$422 million of FY01 surplus transferred to FY02. An additional \$550 million will be transferred from Stabilization in FY03.
- The split between what is to be spent from the Tobacco Settlement and what should be saved for future periods was adjusted from 30:70 to 50:50 and an additional \$60 million was transferred from previously received tobacco payments for general purposes. All of the tobacco settlement funds received in FY03 will be used for current operations.
- Over \$100 million was removed from capital projects funds initially funded from previous years' operational surpluses.

The Commonwealth also took similar measures operationally to achieve balance.

- 3,953 employees took advantage of an early-retirement program offered by the Commonwealth in the executive branch and higher education, saving the Commonwealth \$30.8 million in FY02 and \$165.8 million in FY03. Filling of vacancies in these positions will amount to \$1.4 million in FY02 and \$29 million in FY03. Additional staff reduction measures, including layoffs, have commenced.

- Taxes on cigarettes, capital gains, the elimination of the personal income tax charitable deduction, and decreases in personal income tax exemptions have been enacted increasing tax revenues by an estimated \$1.2 billion in FY03.
- In addition, the FY03 General Appropriations Act increased certain fees.
- During FY02 and FY03, the Governor used her powers under Massachusetts General Laws Chapter 29, Section 9C to reduce spending.
- The Legislature modified the Pension Funding Schedule by extending the terms by five year, thereby reducing FY02's contribution by \$134 million.
- Finally, the Commonwealth refunded \$1.4 billion in older, higher interest debt to take advantage of historically low interest rates to save on current debt service.

### ***Overview of the Financial Statements***

This report includes the reports on the activity and balances of the budgeted funds, non-budgeted special revenue funds, capital project funds, fiduciary funds and the non-appropriated funds of higher education.

The financial operations of these funds are maintained in the Massachusetts Management Accounting and Reporting System, (MMARS). The statewide accounting system is operated by the Commonwealth and contains detailed information summarized in this report.

The SBFR is intended to satisfy the requirements of state finance law, and to present fairly the results of FY02 activity in the Commonwealth's funds. The report contains computations required by state finance law, including the certification of the Stabilization Fund and Tax Reduction Fund.

### ***Basis of Accounting***

The statutory basis of accounting, defined in Massachusetts law, is typically used to budget and control fiscal operations. The statutory basis of accounting is not in conformity with accounting principles generally accepted in the United States of America, (GAAP) as defined for governments by the Government Accounting Standards Board (GASB). I will report the Commonwealth's financial position on a GAAP basis in December, in our Comprehensive Annual Financial

Report, (CAFR). As the Commonwealth is implementing GASB Statements 34, 35, 37 and 38 in FY02, there will be a major divergence between what is contained in the SBFR fund balance, revenues and expenditures and what will be presented in December under GAAP. The major differences will include presentation of the historical cost of infrastructure, the recording of depreciation expense, the presentation of all types of debt on the face of the financial statements and the presentation of those financial statements in an all – encompassing, net assets and net expense format.

In accordance with Massachusetts General Laws, the Office of the Comptroller transmits the Statutory Basis Financial Report (SBFR) on or before October 31<sup>st</sup>. The SBFR report for fiscal year ended June 30, 2002 herein is audited by Deloitte & Touche, Independent Certified Public Accountants, and represents the conclusion of financial activity and the closing of the Commonwealth's books on the statutory basis of accounting for the fiscal year. This audit is conducted in conjunction with the Office of the State Auditor, which provides knowledge, expertise and resources to close and audit the financial statements.

This report includes the budgeted funds, non-budgeted special revenue funds, capital project funds, fiduciary funds and the non-appropriated funds of higher education.

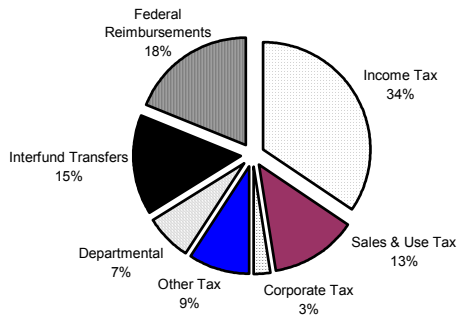
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### ***The Budgeted Funds***

For FY02, uses of budgeted funds exceeded sources of budgeted funds, resulting in an operating deficit of over \$1.6 billion. This deficit is indicative of the aforementioned economic factors.

Any surplus or deficit has to be viewed in a trend. Generally accepted standards indicate that a structural balance is achieved when revenues exceed expenditures over a period of multiple years. Before one-time use of surpluses, the Commonwealth had over a decade-long record of operating gains. In FY02 and FY03 the budget balance relies on significant use of prior year surpluses. In FY04 and in future years the challenge will be to match spending to available revenues before the reserves are depleted.

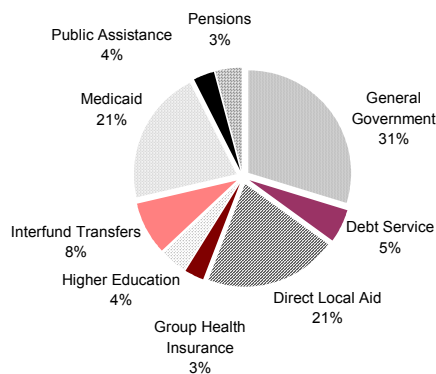
### ***Budgeted Revenues and Other Sources***



In FY02, budgeted revenues and other sources declined 7.4% from FY01 reflecting the unprecedented drop of the income and corporate taxes, offset by increased subsidies to the MBTA and other related financing sources being moved “off budget.” Budgeted tax revenue (adjusted for the change in funding related to the MBTA) decreased by 15.2% over FY01. The decline in income tax receipts is related to deterioration in corporate bonuses and profit sharing as well as an overall decrease in capital gains receipts. These items are estimated to account for over \$1.2 billion of the decline in tax receipts. This is compared to 12% gains in budgeted revenues and 2.5% gains in tax revenues during FY01 from FY00. From a multi-year perspective, the proportion of revenue sources by category to total budgeted revenues and other sources showed a drop in taxes as a proportion of the total budget compared to raises in non-tax categories from FY01 to FY02. Personal income and sales taxes continue to be the largest sources of tax revenue for the Commonwealth. However, for the first time in 50 years of recent tax history, motor fuel tax revenue surpassed corporate tax revenue. This is directly due to the drop in corporate tax revenue.

Further complicating the deficit, budgeted expenditures and other uses, including transfers, increased 7.0% from FY01 to FY02. This increase is due to the increased costs of medicaid (up 13.3%), group health insurance (up 11.9%) and the increasing costs of debt service after FY01’s \$600 million in one-time savings related to defeasance of high interest debt. The Budgeted Funds – Operations table on page 6 displays the FY02 summary of budgeted funds, compared to FY01. Financial statements for each of the 57 individual budgeted funds are included in the financial section of this report. The 2001 balances have been restated due to the transfer of the Mosquito and Greenhead Fly Fund from a budgeted to a non-budgeted fund status.

### ***Budgeted Expenditures and Other Uses***



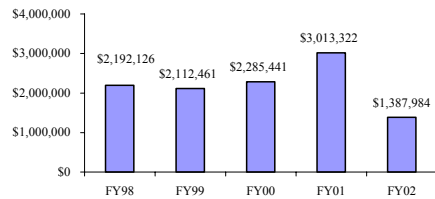
In conducting the budget process, the Commonwealth excludes those “interfund” transactions within the budgeted funds that are included in this report because by their nature, have no impact on the combined fund balance of the budgeted funds. The table Budgeted Funds – Operations isolates this “interfund” activity from the budgeted sources and uses to align forecasts prepared during the budget process to actual amounts in this report. Transfers among the Budgeted Funds increased this year due to amounts transferred from stabilization to other funds to balance the budget for the year. A detailed list of these interfund transfers is included in note 3 to the general purpose financial statements.

The graph of Budgeted Funds – Fund Balance, on page 7, shows the combined fund balance in the budgeted funds for the past five years. This “bottom line” perspective demonstrates the accumulation of resources attributable to balanced budgets over this period. The FY02 ending balance of \$1.4 billion is composed of three items. The Stabilization Fund balance of \$882 million is the largest component. The other components include \$311 million undesignated surplus available for appropriation in FY03 and \$195 million reserved and designated for continuing appropriations and debt service. With the current state of the economy, we now realize the importance of the balance in the Stabilization Fund and its direct correlation to the financial condition of the Commonwealth.

**Budgeted Funds - Operations**  
**(Amounts in thousands)**

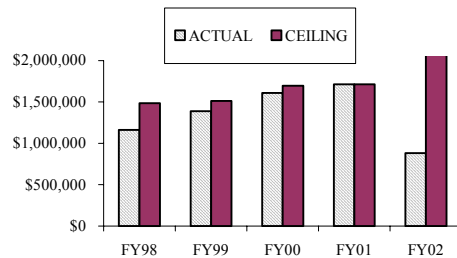
	2001	2002
Beginning fund balances:		
Reserved and designated.....	\$ 278,058	\$ 895,260
Reserved for Tax Reduction .....	7,203	33,565
Reserved for Stabilization Fund.....	1,608,382	1,714,990
Undesignated.....	392,799	369,507
Total.....	<u>2,286,442</u>	<u>3,013,322</u>
Revenues and other sources:		
Taxes.....	16,074,655	13,622,710
Federal reimbursements.....	3,974,158	4,334,934
Departmental and other revenues.....	1,425,894	1,485,249
Interfund transfers from non-budgeted funds and other sources.....	1,385,884	1,732,024
Budgeted revenues and other sources.....	<u>22,860,591</u>	<u>21,174,917</u>
Intragovernmental Service Fund revenues.....	108,527	115,226
Interfund transfers among budgeted funds and other sources.....	822,486	1,759,205
Total revenues and other sources.....	<u>23,791,604</u>	<u>23,049,348</u>
Expenditures and other uses:		
Programs and services.....	19,448,790	20,412,684
Debt service.....	695,171	1,304,735
Pension.....	1,040,121	795,782
Interfund transfers to non-budgeted funds and other uses.....	949,629	287,054
Budgeted expenditures and other uses.....	<u>22,133,711</u>	<u>22,800,255</u>
Intragovernmental Service Fund expenditures.....	108,527	115,226
Interfund transfers among budgeted funds and other uses.....	822,486	1,759,205
Total expenditures and other uses.....	<u>23,064,724</u>	<u>24,674,686</u>
Excess of revenues and other sources over expenditures and other uses.....	<u>726,880</u>	<u>(1,625,338)</u>
Ending fund balances:		
Reserved and designated.....	895,260	195,173
Reserved for Tax Reduction .....	33,565	-
Reserved for Stabilization Fund.....	1,714,990	881,771
Undesignated.....	369,507	311,040
Total.....	<u><u>\$ 3,013,322</u></u>	<u><u>\$ 1,387,984</u></u>

***Budgeted Funds – Fund Balance  
(Amounts in Thousands)***



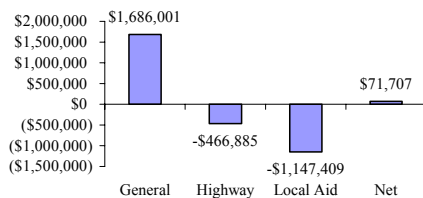
State finance law, as amended during FY02, increased the maximum balance that may accumulate in the stabilization fund to a level of 10% of budgeted revenues and other sources. The law then directs that any amount in excess of this “cap” be transferred to the Tax Reduction Fund for future, one-time, personal income tax rebates. Due to the significant transfers out of stabilization this year, it will be a while before the “cap” will be reached. The details of these calculations can be found on pages 334 through 339 of this report.

***Stabilization Fund –  
Fund Balance  
(Amounts in Thousands)***



The graph, Stabilization Fund Balance portrays this “cap” and the balance of the fund over a five-year period. Despite the Commonwealth’s positive financial condition, a few cautionary notes are merited. There are certain problems with the definitions in the state finance law, enacted in 1986 and continued with slight modifications to the present. A balanced budget, defined as the “Consolidated Net Surplus,” is the combined undesignated fund balance of the General, Local Aid, and Highway Funds. According to this restricted definition, fiscal balance was achieved in FY02, but only after transfers from stabilization and the general capital project fund. This definition excludes 52 other budgeted funds with a combined undesignated fund balance of nearly \$1.2 billion including reserves for continuing appropriations (the largest being stabilization). The Commonwealth should adopt a more straightforward definition of fiscal balance. State finance law should be amended to rationalize the contributions to the Stabilization Fund to include the entire population of budgeted funds.

***“Consolidated Net Surplus”  
Prior to Transfers  
(Amounts in Thousands)***



Under current general laws, an amount equal to 0.5% of tax revenues is retained in the funds contributing to the calculation. Any amount in excess of this is available for transfer from the General and Local Aid funds to a Capital Projects Fund in lieu of bonds (the Open Space Acquisition Fund), leaving any balance to be transferred to the Stabilization Fund.

Further complicating this issue is the existence of a large number of “minor” budgeted funds. Over the past several years, dozens of new “minor” funds have been created. These funds split off revenues and expenditures previously accounted for as part of a major fund, such as the General Fund. A number of these funds have structural imbalances leading to chronic deficits. The trend to fragment the budget into such special interest funds should be addressed with a plan to either consolidate to a more reasonable number of funds or eliminate funds that are structurally in deficit.

### ***The Non-Budgeted Funds***

The Non-Budgeted Funds represent operations in which the government has imposed its sovereign authority, but has excluded these operations from the annual budget process. During FY02, the Commonwealth maintained 35 of these funds. The largest funds in activity include the Lottery, Federal Grants, Debt Defeasance, Health Care Security Trust (the recipient of tobacco settlement funds), Grant Anticipation, Sewer Rate Relief, the Medical Security Trust and the Uncompensated Care Funds. New funds were added this year including the State Racing Fund and the Division of Professional Licensure Fund. The Mosquito and Greenhead Fly Fund became a non-budgeted fund after formerly being a budgeted fund. This change necessitated a restatement of FY01 amounts to conform to current presentation. These funds are commonly referred to as special or dedicated revenue funds whose revenues are matched to related expenditures.

The table, Non-Budgeted Funds – Operations, includes a summary of the FY02 non-budgeted funds. Financial statements for each of the individual funds are included in the financial section of this report. Several of these funds are worth mentioning. At June 30, 2002, the Federal Grants Fund had a positive fund balance, but there is a deficiency in cash within the fund. This situation results in the Commonwealth drawing funds from the federal government a few days after applicable cash disbursements to assure an “interest neutral” timing of the federal – state cash exchange. These requirements were established by the Cash Management Improvement Act of 1990. Within the Lottery Funds, gross revenues continued to increase this fiscal year. The Lottery continues to be a strong source of cash flow for the Commonwealth.

#### **Non-Budgeted Funds - Operations (Amounts in thousands)**

	2001	2002
Beginning fund balance.....	\$ 1,088,429	\$ 882,976
Revenues and other sources:		
Taxes.....	678,205	718,621
Assessments.....	498,269	452,510
Federal grants and reimbursements.....	2,142,304	2,496,932
Tobacco Settlement revenue.....	242,470	304,518
Departmental and miscellaneous.....	4,642,678	5,041,971
Transfers and other sources.....	994,328	434,493
Total revenues and sources.....	9,198,254	9,449,045
Expenditures and other uses:		
Programs and services.....	6,432,539	7,199,414
Debt service.....	62,692	77,413
Transfers and other uses.....	2,908,476	2,199,098
Total expenditures and uses.....	9,403,707	9,475,925
Excess (deficiency) of revenues and other sources over expenditures and other uses.....	(205,453)	(26,880)
Ending fund balance.....	\$ 882,976	\$ 856,096

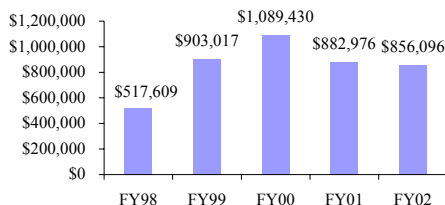


The Health Care Security Trust Fund receives all revenues from the Master Settlement Agreement (MSA) between the states and the tobacco industry to recover healthcare costs for tobacco related illnesses. The MSA estimates the Commonwealth revenues for the first 25 years of the settlement to be approximately \$7.6 billion. However, this estimate is prior to future adjustments, including adjustments for inflation and changes in the volume of domestic cigarette sales. In FY02, the Commonwealth received over \$304.5 million or 90.7% of the estimated amounts shown in the agreement. Of the \$304.5 million, over \$154 million was transferred to the Tobacco Settlement Fund, a budgeted fund. In addition, \$60 million was transferred out to the General Fund. The majority of expenditures from the fund this year were for Health and Human Services, Elder Affairs and Medicaid costs.

Beginning in FY01, a board of public and private sector investment experts, appointed by the Governor, the Attorney General and the Treasurer-Receiver-General, started managing the investment of funds in the trust. This board has broad discretion on investment choices to increase the assets in the fund. The board has chosen to use the Pension Reserves Investment Management Board (PRIM) to invest the assets, leveraging their investment managers' expertise and the economies of scale. The total return on investment in this fiscal year was negative tracking the stock market as whole. For FY02, 50% of payments into the fund and investment earnings thereon were transferred from the trust to the budgeted funds for appropriation by the Legislature, a rise from 30%. For FY03, the Legislature has mandated that 100% of the payments received will be used to balance the budget.

Federal Grant Anticipation Notes, (GANS) activity related to the Central Artery / Tunnel Project (CA/T) continued this year. During FY98, the Legislature authorized the issuance of up to \$1.5 billion in GANS to finance the current cash needs of the Project. As of June 30, 2002, all of the GANS have been issued. These GANS mature between 7 to 17 years from the date of issuance and are redeemed by pledged future federal reimbursements. The GANS are not considered general obligation debt of the Commonwealth. Activity related to issuance of GANS and the accumulation of pledged funds and the payment of debt service is accounted for in the Grant Anticipation Note Trust Fund. The \$113 million surplus in FY02 represents \$80 million held for payment of interest on the GANS and \$33 million in cash from the GANS issuance that will be expended on the construction of the CA/T.

***Non-Budgeted Funds –  
Fund Balance  
(Amounts in Thousands)***



The universal health care funds, including the Uncompensated Care, Labor Shortage and Medical Security Trust Funds, have increased their annual revenue to over \$1.2 billion. However, \$331 million was transferred out to fund operations this year due to the lagging economy. As of the end of FY02, they have a combined fund balance of over \$119 million.

The graph Non-Budgeted Funds Balance shows the combined fund balance in the Non-Budgeted funds for the past five years. In each year, the entire balance is designated for the specific purpose of the fund. The only component of overall growth in fund balance in these funds this fiscal year was due largely to deposits into the Health Care Security Trust and Community Preservation Trust Funds. As indicated in previous years, more consolidation and elimination is needed for these

funds. For example, the Government Land Bank Fund has a chronic structural fund deficit. The FY02 deficit balance of \$35 million remains an unbudgeted drain in cash flows in the General Fund. While steps have been taken to stop the growth in this deficit, the Fund should be abolished and the deficit transferred into the General Fund. An additional deficit exists in the Motor Vehicle Inspection Fund. However, the enabling statute to the Fund mandates that the Fund must be in balance by June 30, 2005. A periodic re-examination of all non-budgeted funds represents sound financial practice.

### ***The Capital Projects Funds***

The purpose of these funds is to construct or acquire capital assets for governmental use. The Governor may propose capital outlay budgets, which, upon enactment by a two-thirds vote of the Legislature and approval by the Governor, become capital outlay acts. Numerous acts may be combined for reporting in an individual Capital Project Fund, but each act is accounted for separately within the Capital Projects Fund. These accounts record authorizations for expenditures in itemized capital appropriation accounts and equivalent authorizations to issue bonds or notes in anticipation of federal reimbursements.

The structure of these funds is that each capital outlay authorization is in balance, creating authorization for inflows, which may be from sales of bonds, federal reimbursements or other revenues and authorization for expenditures. Imbalances due to timing differences develop when the expenditure precedes the inflow of funds from the sale of bonds or federal reimbursements. Because of federal tax arbitrage rules, it is more difficult to sell bonds in anticipation of expenditures. The sale of bonds in advance is not commonplace in the Commonwealth.

The Commonwealth issued nearly \$2.9 billion in debt proceeds this year. Of this amount, nearly \$1.2 billion was in the form of general obligation refunding bonds, taking advantage of low interest rates. These refundings generated approximately \$47.1 million in present value debt service savings. In June 2002, the Commonwealth issued another \$330.1 million of special obligation bonds, of which \$194.1 million was for a refunding. The escrow funded by the refunding bonds and related premium secured \$190.1 million in special obligation bonds maturing on June 1, 2003, 2004, 2006 and 2008. The interest on the newly issued refunding bonds is also paid from this escrow until the final redemption. This technique, which is normally referred to as a "crossover refunding," results in economic savings, but does not result in the defeased debt being removed from the Commonwealth's books until the call dates.

A significant portion of the Capital Projects activity continues to relate to the Central Artery / Tunnel Project (CA/T). The CA/T has been the target of an enormous amount of public scrutiny. As indicated in the notes to the Combined Financial Statements – Statutory Basis, the financial disclosure portion of the project is under review with various federal agencies. The Commonwealth has aggressively responded to these concerns regarding the integrity of the cost estimates. For the third year, an independent evaluation of the entire estimate for the project has been undertaken. The current cost estimate of the project

**Central Artery / Tunnel Project**  
**(Amounts in Billions)**

Sources of Funds:	2001	2002
Federal Funds	\$7.049	\$7.049
GANS	1.500	1.500
Massachusetts Turnpike Authority	1.706	1.850
Massachusetts Port Authority	0.300	0.365
Other Commonwealth Debt	3.077	3.711
Commonwealth Operating Funds and Investment Earnings	0.843	0.150
<b>Total Sources</b>	<b>\$14.475</b>	<b>\$14.625</b>
<b>Costs of Construction:</b>		
Actual Costs through end of FY	\$10.425	\$11.655
Estimated Spending:		
FY02	1.472	-
FY03	1.122	1.254
FY04	0.985	0.907
FY05	0.336	0.588
FY06	0.135	0.221
<b>Total Estimated Costs of Construction:</b>	<b>\$14.475</b>	<b>\$14.625</b>

stands at \$14.625 billion. The federal government has capped its contribution to this project and the finance plan includes state sources to fund this increase. The project is over 83% complete as of June 30, 2002.

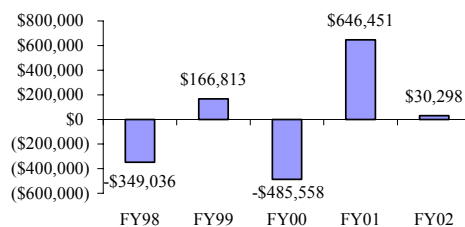
It is important to note that the change in cost is primarily due to the Federal Highway Administration retroactively changing the definition of project cost for prior fiscal years, as a result certain expenses and the associated revenues used to finance these expenses have been added to the project budget and the summary tables presented here.

During FY00, the Commonwealth put in place a new management team for the project that is committed to full, timely disclosure about schedules and costs. The bulk of the spending remaining on the Project will occur during FY02 and FY03. Completion is expected to be during FY06. The east-west portion (Interstate 90) is expected to open in December of 2002, with the northbound portion (Interstate 93) expected to open in January of 2003. The southbound portion (Interstate 93) is expected to partially open in January of 2004. Substantial completion is expected in February 2005, with "finish work" completed in FY06.

Pursuant to statute and agreements with the Massachusetts Turnpike Authority (the MTA) and the Massachusetts Port Authority (MassPort), the entities have committed to significant ongoing contributions to the Commonwealth as part of the financing for this project. These funds are in addition to funds from the Commonwealth and federal funds for the project.

The graph Capital Projects Funds – Fund Balance (Deficit) shows the combined fund balance in Capital Projects Funds for the past five years. The graph shows a surplus in the funds in FY02. However, the majority of these funds remain in deficit due to the timing differences between bonding and expenditure.

**Capital Projects Funds –**  
**Fund Balance (Deficit)**  
**(Amounts in Thousands)**



The Capital Projects Funds – Operations table on the next page, includes the FY02 Capital Projects Funds, summarized and compared to FY01. Financial statements for each of the individual funds are included in the financial section of this report.

The Administration has implemented a coordinated fiscal strategy for the management of Capital Projects Funds. This strategy includes a five-year capital budget linked to debt management and cash management. The focus of this strategy is to manage capital spending and outstanding debt to levels the Administration considers appropriate for the Commonwealth. An important part of the strategy is to control capital spending within an annual administrative "cap." As additional capital outlays have been enacted and significant projects such as the CA/T have been authorized, it becomes more challenging to restrain spending to such limits. Strategies to manage this situation, such as alternative financing for capital projects, should continue.

**Capital Projects Funds - Operations**  
(Amounts in thousands)

	2001	2002
Beginning fund balance (deficit).....	\$ (485,558)	\$ 646,451
Revenues and other sources:		
Federal grants and reimbursements.....	1,035	339
Departmental and miscellaneous.....	64,262	54,671
Payment from Authorities.....	265,000	-
General and special obligation financing.....	1,911,676	1,357,960
Proceeds of refunding bonds.....	998,729	1,501,415
Transfers from budgetary surplus.....	34,462	-
Transfer for Federal Reimbursements.....	458,659	495,551
Transfer in due to debt defeasance .....	624,589	34,590
Transfers and other sources.....	1,166,878	292,661
Total revenues and other sources.....	5,525,290	3,737,187
Expenditures and other uses:		
Acquisition of assets.....	2,663,464	2,696,159
Payments to refunded bond escrow.....	998,729	1,276,562
Transfers and other uses.....	731,088	380,619
Total expenditures and other uses.....	4,393,281	4,353,340
Excess (deficiency) of revenues and other sources over expenditures and uses.....	1,132,009	(616,153)
Ending fund balance (deficit).....	\$ 646,451	\$ 30,298

***The Fiduciary Funds (Excluding Agency Funds)***

The Fiduciary Funds record the Commonwealth's responsibility for assets it controls on behalf of other parties. Examples of such funds are the Unemployment Compensation and Pension Trust Funds. The table on the following page, which excludes assets held on a purely custodial capacity in so-called Agency Funds, summarizes the FY02 activity of the Fiduciary Funds. Over 92% of this Fiduciary Fund activity is related to the Commonwealth's Pension Fund detailed in fund statements found in this report.

The \$2.8 billion operating loss in this fund group is attributable to two factors:

- The loss in value of pension assets due to stock market declines, and
- Payment to the unemployed in the Commonwealth exceed employee contributions to the Unemployment Compensation Trust Fund by over \$850 million.

The Commonwealth is in the process of updating its pension valuation. The valuation is based on data as of January 1, 2002. Details of this valuation are outlined in note 10. While the value of pension assets has dropped since this valuation, the public retirement system remains strong at 81.1% funded. Due to market conditions after June 30, this percentage could be lower.

**Fiduciary Fund - Operations (Excluding Non-Expendable Trusts)**  
(Amounts in thousands)

	2001	2002
Beginning fund balance.....	\$ 32,860,778	\$ 30,957,564
Revenues and other sources:		
Taxes.....	894,161	862,033
Federal reimbursements.....	41,253	395,390
Departmental and other revenues.....	1,701,987	1,624,018
Interfund transfers and other sources.....	24,649	29,740
Unrealized and realized investment earnings / (losses).....	(1,819,686)	(1,658,292)
Total revenues and sources.....	842,364	1,252,889
Expenditures and other uses:		
Expenditures.....	2,653,885	4,031,260
Interfund transfers.....	91,693	95,673
Total expenditures and uses.....	2,745,578	4,126,933
Excess (deficiency) of revenues and sources over expenditures and uses.....	(1,903,214)	(2,874,044)
Ending fund balance.....	\$ 30,957,564	\$ 28,083,520

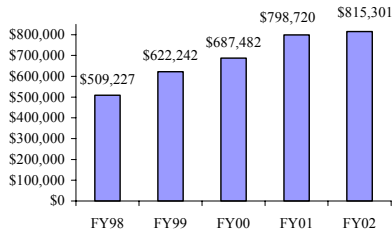
***The Non-Appropriated Funds of Higher Education***

The SBFR includes the financial operations of the non-appropriated funds of the 25 Institutions of Higher Education in the statistical section of this report. Over the past few years, significant efforts have been taken by our office and the institutions to improve the accuracy and timeliness of this Higher Education segment of the financial report. Each Institution of Higher Education is authorized and directed in its enabling statute to collect, retain and expend certain fees, rents, sales, donations, federal financial participation and other types of revenue through campus based systems. These financial resources are integral parts of the total financial activity of each campus. They also represent resources in addition to amounts made available from Commonwealth appropriations.

**Non-Appropriated Funds Of Higher Education - Operations**  
(Amounts in thousands)

	2001	2002
Beginning fund balance.....	\$ 687,482	\$ 789,720
Revenues and other sources:		
Federal Grants and reimbursements.....	235,733	273,617
Departmental and miscellaneous.....	900,245	952,590
Transfers and other sources .....	402,061	384,434
Total revenues and other sources.....	1,538,039	1,610,641
Expenditures and other uses:		
Programs and services.....	1,032,347	1,144,925
Transfers and other uses.....	403,454	440,135
Total expenditures and uses.....	1,435,801	1,585,060
Excess (deficiency) of revenues and other sources over expenditures and other uses.....	102,238	25,581
Ending fund balance.....	<u>\$ 789,720</u>	<u>\$ 815,301</u>

***Non-Appropriated Funds of Higher Education – Fund Balance***  
(Amounts in Thousands)



The Non-Appropriated Funds for Higher Education – Operations table includes the FY02 funds, summarized and compared to FY01. Financial statements for each of the individual funds are included in the statistical section of this report. The graph Non-Appropriated Funds for Higher Education – Fund Balance shows the combined fund balance for the past five years. The combined balance represents \$641 million for the University of Massachusetts, \$93 million for the State College system and \$81 million for the Community Colleges. These balances are designated for specific purposes, such as restrictions on endowments or other specialized purposes specified by the funding contributions.

## ***Conclusions And Recommendations***

The Commonwealth has many accomplishments in FY02 of which it can be proud.

The Office of the Comptroller has undertaken a major effort to build a more collaborative working relationship among members of this office and Chief Fiscal Officers (CFO) of the Commonwealth in a program we call "PARTNERS in Financial Management". The second CFO conference brought together CFOs from across the Commonwealth for two days of meetings. PARTNERS stands for people, accountability, responsibility, trust, negotiation, efficiency, risk assessment and mitigation, and solutions. We have enhanced the mantra that all systems, big and small, depend on people who are integral to those systems. This recognizes that fiscal officers of the Commonwealth are all accountable for their actions, ensuring the uncompromising integrity of the financial statements of the Commonwealth. We must maintain this standard to maintain the public trust. The Office of the Comptroller continued to increase delegation this year to individual departments due to the level of trust that we have with them, based on prior results. We must continually strive to balance accountability with efficiency, especially in order to continually serve the Citizens of the Commonwealth, our customers. This balancing also targets controls to result in effective risk mitigation. Finally, we strive to find solutions to many of the Commonwealth's problems in conjunction with the rest of the CFOs, so that full input is heard.

This December when we release the Commonwealth's Comprehensive annual financial report, it will take on a new look and feel. With the implementation of GASB Statement 34 the Commonwealth's financial statements will include a more comprehensive view of the financial condition accruing all long-term assets and liabilities on the balance sheet including Commonwealth infrastructure. Underlying the change to this document was an extensive statewide project to:

- value Commonwealth infrastructure at historical cost;
- redesign underlying financial systems; and,
- work with the 25 institutions of Higher Education and 30 public authorities to make changes to their financial systems. This is so that their financial statements, which the Commonwealth must rely on, are also compliant with GASB Statement 34.

This was a huge undertaking. It was conducted with little or no additional funding and has been highly successful.

Last year, the Commonwealth started the process of consolidating its web sites to better serve the Citizens of the Commonwealth. With service to our customers as key, the Commonwealth's new web portal "Mass.Gov" promises to bring government closer to the people. Mass.Gov is customer-focused. It provides services according to the needs of citizens and businesses, not according to government structure. Citizens are able to quickly find the information and services they need without having to navigate the bureaucracy of government. Mass.Gov provides comprehensive, integrated, and seamless services that our

Citizens will be able to bring into their homes or businesses at their convenience, twenty-four hours a day, seven days a week. The Office of the Comptroller contributed to joint projects with ITD to build internet based shared services for use by all internet based applications. In addition we continued to roll out new technology with real benefits to state department and taxpayers. This year we released an internet based front end to the Billing and Accounts Receivable System allowing institutions of Higher Education to provide information regarding non performing receivables to the Comptroller for potential intercept against commonwealth payments or tax refunds. This technology was developed so that any government entity authorized in statute could take advantage of this tool. In addition we piloted new financial software simplifying the vendor registration process, reducing administrative workloads in departments and reducing the time from contract registration to completed vendor registration.

In May of 2002, the Legislature enacted Information Technology Bond III, authorizing \$300 million for the Commonwealth to upgrade its technology infrastructure. Included in this legislation is funding for the Commonwealth to upgrade the statewide financial system from 1980's, MMARS to a state of the art internet-based financial system. Last month, the Office of the Comptroller and the Information Technology Division entered into a joint project with American Management Systems, (AMS), of Fairfax Virginia, to upgrade this key financial system. The new system is slated to be completed in time for the opening of FY05. This project will focus on changing business practices in order to minimize customization to this product. This strategy will insure the Commonwealth can upgrade to current releases in the future at a reasonable cost. The goal is to keep current with technology in the future and at the same time control the total cost of system ownership. Benefits will accrue directly to the users of the financial system. In addition, this updated technology will allow for the future integration of Commonwealth internet-based applications into "back office" financial systems. The Comptroller, the Information Technology Division and AMS have assigned a highly motivated, highly dedicated team to this project to insure its success.

Building upon the observations of this letter, a detailed review of these financial statements suggests the need for action to further improve and strengthen state finance law and fiscal practice.

**The Commonwealth must constantly monitor and update its systems and controls.** Upon taking office in January of 1999, I began a multi-year effort to expand awareness of and the quality of internal controls throughout the Commonwealth. We have asked each department, at its highest levels, to assess its risks and target controls to manage those risks efficiently and effectively. Toward this end, the Office of the Comptroller, in conjunction with the Office of the State Auditor, has continued a multi-pronged effort to improve controls throughout the Commonwealth. This effort must continue.

**The Commonwealth should adopt a more straightforward definition of fiscal balance including all of the budgeted funds.** The idiosyncratic definition of fiscal balance that includes a portion of fund balance within three of the budgeted funds should be expanded to include all 54 funds.



**Minor Budgeted Funds with Deficits  
(Amounts in Thousands)**

Environmental Funds:		
Environmental Challenge Fund.....	\$	(797)
Toxics Use Reduction Fund.....		(8,416)
Environmental Permitting and Compliance Assurance Fund.....		(50,872)
Underground Storage Tank Petroleum Product Cleanup Fund.....		(19,360)
Environmental Law Enforcement Fund.....		(4,482)
Public Access Fund.....		(414)
Harbors and Inland Waters Maintenance Fund.....		(6,244)
Marine Fisheries Fund.....		(6,498)
Watershed Management Fund.....		(2,104)
Low-Level Radioactive Waste Management Fund.....		(433)
Clean Air Act Compliance Fund.....		(1,700)
Second Century Fund.....		(2,819)
Leo J. Martin Recreational Fund.....		(240)
Subtotal Environmental Fund Group.....	\$	(104,379)
Children's and Seniors' Health Care Assistance Fund.....		(60,784)
Transitional Aid to Needy Families Fund.....		(7,618)
Child Support Penalty Fee Fund.....		(498)
Social Services Program Fund.....		(2,314)
Antitrust Enforcement Fund.....		(2,901)
Victim and Witness Assistance Fund.....		(13,323)
Intercity Bus Capital Assistance Fund.....		(5,562)
Local Consumer Inspection Fund.....		(574)
Subtotal Budgeted Other.....		(93,574)
Total Minor Budgeted Funds with Deficits .....	\$	(197,953)

**The Commonwealth should reduce the number of funds and eliminate funds that have chronic deficits.** The Commonwealth currently maintains over 122 individual funds to record its financial activity. This excessive number of funds fragments the Commonwealth's financial picture. Many of these funds have structural imbalances leading to chronic deficits. The effort to reduce the number of funds should continue. A fund should be a self balancing set of accounts where decision makers want to set aside a specific set of revenues to fund a specific set of activities. Nineteen of the 54 budgeted funds are in the environmental fund group. Thirteen of these nineteen funds contribute to accumulated deficits of \$104.4 million in this fund group. The revenues and expenditures in these funds should be brought into alignment either through increased fees and assessments or decreases in appropriation, otherwise we should acknowledge that these services are to be funded from general tax revenues and consolidate this activity into the general fund. The table, Minor Budgeted Funds with Deficits identifies funds with significant deficits that remained unfunded or continued to grow during FY02 or where no plan exists to bring them into balance. The structure of these funds should be changed to balance revenues with expenses or the funds should be eliminated and their activity consolidated into the General Fund.

**The Commonwealth should continue to emphasize optimization of both tax and non-tax revenues.** This statewide campaign has generated over \$253 million in revenues since FY96. The revenue optimization strategy should continue.

I again would like to express my thanks to the many dedicated people within the Office of the State Comptroller. We have had another successful year within the office. Our office has undertaken many tasks this year. We are embarking on the redesign of the state accounting system, MMARS. This will be a significant effort but will provide enduring benefits to the Commonwealth. I am proud to have all the employees of the Comptroller's Office on my team to help tackle these and other difficult issues of the future.

Respectfully submitted,

Martin J. Benison  
Comptroller of the Commonwealth